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Proposed statement on auditing standards:
Unaudited replacement cost
information; Unaudited replacement cost
information; Exposure draft (American Institute of
Certified Public Accountants), 1976, Dec. 15

American Institute of Certified Public Accountants. Auditing Standards Executive Committee

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EXPOSURE DRAFT

**PROPOSED STATEMENT ON AUDITING
STANDARDS: UNAUDITED REPLACEMENT
COST INFORMATION**

DECEMBER 15, 1976

Issued by the Auditing Standards Executive Committee of the
American Institute of Certified Public Accountants
For Comment From Persons Interested in Auditing and Reporting

Comments should be received by February 15, 1977, and addressed to
Auditing Standards Division, File Ref. No. 3870
AICPA, 1211 Avenue of the Americas, New York, N.Y. 10036



American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 15, 1976

To Practice Offices of CPA Firms; Members
of Council; Technical Committee Chairmen,
State Society and Chapter Presidents,
Directors and Committee Chairmen; Organizations
Concerned with Regulatory, Supervisory
or Other Public Disclosure of Financial
Activities; Persons Who Have Requested Copies:

An exposure draft of a proposed Statement on Auditing Standards entitled
"Unaudited Replacement Cost Information" accompanies this letter.

This proposed Statement responds to the urging of the SEC in Accounting Series
Release (ASR) No. 190 that the Auditing Standards Executive Committee develop
appropriate standards for the involvement of the auditor with unaudited replace-
ment cost information presented in audited financial statements in accordance
with SEC Regulation S-X.

This proposed Statement recommends that the auditor perform limited inquiry
procedures to provide the auditor with an understanding as to whether (a) the
replacement cost information is prepared and presented in conformity with Regu-
lation S-X of the Commission and (b) disclosures regarding the replacement cost
information are consistent with management's responses to the auditor's in-
quiries. The proposed Statement also provides guidance as to the auditor's re-
porting responsibilities in connection with unaudited replacement cost
information.

Comments and suggestions on any aspect of the enclosed draft are sought and will
be appreciated. They should be addressed to the Auditing Standards Division, File
Ref. No. 3870, at the AICPA in time to be received by February 15, 1977. The
Auditing Standards Executive Committee will be particularly interested in the
reasoning underlying comments and suggestions.

Sincerely,

A handwritten signature in cursive script that reads "Kenneth P. Johnson".

Kenneth P. Johnson, Chairman
Auditing Standards Division

A handwritten signature in cursive script that reads "John F. Mullarkey".

John F. Mullarkey, Director
Auditing Standards Division

PROPOSED STATEMENT ON AUDITING STANDARDS

UNAUDITED REPLACEMENT COST INFORMATION

Replacement Cost Information Required in Filings With the Securities and Exchange Commission

1. Although generally accepted accounting principles do not require the presentation of replacement cost information in financial statements, certain companies are required by Regulation S-X of the Securities and Exchange Commission (the Commission) to include in a note or a separate section of audited financial statements filed with the Commission specified replacement cost information regarding inventories, cost of sales, productive capacity, and depreciation. Companies supplying such information are to disclose the methods used in determining the amounts and are to furnish any additional information that in the opinion of management is necessary to prevent the information from being misleading.

2. The replacement cost information ordinarily is developed by management, using assumptions and techniques that have not yet been standardized, and consequently may differ from company to company and from year to year. Accordingly, the various approaches to calculating the replacement cost information must be viewed as experimental.

3. The Commission does not require that the replacement cost information be audited but has urged that appropriate standards be developed concerning the involvement of the auditor. In response to such request, this Statement pro-

vides guidance concerning the procedures the auditor should apply to unaudited replacement cost information presented in audited financial statements.

4. The auditor should read the unaudited replacement cost information and apply the limited procedures described in paragraph 5. The objective of the limited procedures, which consist of selected inquiries, is to provide the auditor with an understanding as to whether (a) the replacement cost information is prepared and presented in conformity with Regulation S-X of the Commission and (b) management's disclosures with respect to the replacement cost information are consistent with management's responses to such inquiries. The objective of the limited procedures differs significantly from the objective of an examination of financial statements in accordance with generally accepted auditing standards. The objective of an audit is to provide a reasonable basis for expressing an opinion on the financial statements under examination. The limited procedures do not provide a basis for the expression of such an opinion because they do not contemplate either (a) tests of records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation, or confirmation, or (b) certain other procedures ordinarily performed during an audit.

Procedures to Be Applied

5. The auditor should apply the following limited procedures to

unaudited replacement cost information included in audited financial statements filed with the Commission:

- a. Inquire of management as to whether the unaudited replacement cost information has been prepared and presented in accordance with the requirements of Regulation S-X.¹
- b. Inquire of management as to the methods selected to calculate replacement cost information and the reasons for selecting them, including consideration given by management to (1) current replacement programs, (2) plans or expressed intentions concerning future replacements, (3) plans or expressed intentions not to replace certain inventories or productive capacity, and (4) technological changes that have occurred in the industry.
- c. Inquire of management as to procedures used to compile the data supporting the replacement cost information and as to the relationship between data supporting the replacement cost information and data supporting the audited financial information—for example, Are the useful lives used to calculate depreciation on the historical cost basis the

¹ Regulation S-X of the Commission requires that the unaudited replacement cost information be prepared on a reasonable basis and disclosed in good faith.

same as those used on the replacement cost basis? Are inventory quantities used in the determination of inventory value for the historical cost financial statements the same as inventory quantities used to calculate the replacement cost information?

- d. Inquire about the methods and bases used by management to calculate any additional replacement cost information disclosures, such as historical relationships between cost of sales and selling prices or the effect of technologically improved capacity replacements on operating costs.
- e. If management has changed the method of calculating replacement cost information, inquire as to the reasons for using a different method from that used in the previous fiscal period.
- f. Consider whether the disclosures with respect to such information are consistent with management's responses to the above inquiries.

The auditor has no obligation to perform any procedures to corroborate management's responses concerning the unaudited replacement cost information.

Form of Reporting

6. The auditor's report on the audited financial statements filed with the Commission ordinarily need not make reference to the unaudited replacement cost information included in the financial statements, or to the auditor's limited procedures regarding such information. If the auditor concludes that there is a material inconsistency between the unaudited replacement cost information and the audited financial information, he should determine whether the audited financial statements, his report, or both require revision. If he concludes that they do not require re-

vision, the auditor should request the client to revise the unaudited replacement cost information.

7. The auditor's report should be expanded if (a) the auditor concludes that the unaudited replacement cost information has not been prepared or presented in accordance with the requirements of Regulation S-X,² (b) the auditor has been unable to apply the limited procedures required by paragraph 5, or (c) the unaudited replacement cost information is not clearly marked as "unaudited" or includes an indication that the auditor performed any procedures regarding the information, unless it also indicates that the auditor does not express an opinion on the information presented.

8. The following are examples of explanatory paragraphs an auditor might use in certain of the above circumstances.

Unaudited Replacement Cost Information Not Prepared (Not Presented) in Accordance With the Requirements of Regulation S-X

Note X, "Unaudited Information," contains replacement cost information that we did not audit and accordingly we do not express an opinion on such information. However, as a result of our limited procedures, which consisted of inquiries concerning such information, we do not believe that (describe applicable information) has been prepared (presented) in accordance with Regulation S-X of the Securities and Exchange Commission because (state reasons).

Auditor Unable to Apply the Limited Procedures

Note X, "Unaudited Information," contains replacement cost information that we did not audit and accordingly we do not express an opinion on such information. In addition, we have been unable to apply the required limited procedures with respect to the unaudited replacement cost information.

² See footnote 1.

Replacement Cost Information Required to Be Presented in Annual Reports to Shareholders

9. Companies required to include unaudited replacement cost information in financial statements filed with the Commission are also subject to Regulation 14A of the Commission, which requires that financial statements included in annual reports to shareholders that are to be used for the solicitation of proxies must be in substantial conformity with the financial statements filed with the Commission.³

10. This Statement is also applicable to quantified replacement cost information included in the annual report to shareholders. If the annual report includes a generalized description of the impact of changes in the prices of specific goods and services, the auditor should read the generalized description and compare the information included therein with the unaudited replacement cost information in the financial statements filed with the Commission. The auditor should not refer to such generalized description in his report if it (1) is not inconsistent with either the audited financial statements or the unaudited replacement cost information included in, or prepared for inclusion in, the financial statements filed with the Commission, (2) does not contain a material misstatement of fact, and (3) is clearly marked as "unaudited". The auditor also need not refer to such generalized description if it indicates that the auditor performed any procedures but also indicates that the auditor does not express an opinion on the generalized description.

³ The staff of the SEC has indicated, however, that while the financial statements included in annual reports distributed to shareholders need not include the unaudited replacement cost information required by Regulation S-X, they should include a generalized description of the impact of changes in the prices of specific goods and services and a reference to the unaudited replacement cost information contained in the financial statements filed with the SEC.

**Replacement Cost Information
Not Required to Be Presented
in Financial Statements**

11. Some companies not required by Regulation S-X to present unaudited replacement cost information may include such information, prepared either in a manner consistent with the requirements of Regulation S-X or in a different manner, in audited finan-

cial statements. Users of such financial statements may not be able to differentiate between required replacement cost information with respect to which an auditor has performed certain limited procedures and other replacement cost information that is not required and with respect to which such procedures have not been performed. In such cases, the provisions of this Statement are applicable unless the note or separate section of the

financial statements including such unaudited information⁴ states that the auditor has neither examined the unaudited replacement cost information nor applied the limited procedures described in this Statement.

⁴ Paragraph 31 of SAS No. 2 describes the auditor's reporting obligations when unaudited information appears in financial statements on which the auditor is reporting.